No. 22802

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE SIXTY TRUST,

Appellant,

vs.

WM. B. ENRIGHT, TRUSTEE, ETC.,

Appellees.

REPLY BRIEF FOR APPELLANT.

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List of Abbreviations.

P.	Petition
A.	Answer to Petition for Reorganization
R.	Transcript of Record
AR.	Additional Transcript of Record
V. I	Volume I of Transcript of Proceedings held on June 28, 1967
V. II	Volume II of Transcript of Proceedings held on June 30, 1967
V. III	Volume III of Transcript of Proceedings held on June 30, 1967
Tr.	Transcript of Proceedings held on September 21, 1967
Ex.	Exhibits to hearing held on June 28, 1967 and June 30, 1967

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I.

Jurisdictional Statement.

The basis upon which this Court has jurisdiction to review the propriety of the Order of the District Court from which the instant appeal was taken was set forth under this heading in the Opening Brief For Appellant and shall not be repeated.

II.

Statement of the Case.

The relevant historical and evidentiary background of this controversy was set forth under this heading in the Opening Brief for Appellant filed herein and reference is made thereto. The Brief filed on behalf of Appellee Enright incorrectly asserts that Appellant has abandoned its attack on the allegations of the Petition and has accepted the findings that there is an equity in the real property and that it is reasonable to expect

a Plan of Reorganization to be effected. Such is not the case. As set forth in the Opening Brief for Appellant under the heading Specification of Errors Relied Upon, Appellant claims that the District Court erred in adopting and approving the Referee's Report, Findings of Fact, and Conclusions of Law. Since the Report, Findings and Conclusions were listed as Errors Relied Upon by Appellant in its Opening Brief, Appellant clearly has not "abandoned" any issue or "accepted" any such findings. The bases upon which Appellant claims the Report, Findings and Conclusions to be erroneous are set forth in the Objections to Proposed Report of Special Master [R. 62-75], Objections to Report of Special Master [R. 84-96], and Supplementary Objections to Report of Special Master [R. 97-100].

III.

Questions for Decision by This Court.

The sole issues before this Court are whether the District Court erred in approving the Report, Findings and Conclusions of Special Master; whether two individuals may segregate a portion of their individually-owned property, transfer that property to a controlled corporation, and then cause that corporation to file a Reorganization Petition so as to bring said property within the automatic injunctive power of the District Court and thus protect their individual equity in said property from foreclosure by the holder of deeds of trust encumbering said property; whether such a transfer on the eve of filing of the Reorganization Petition shows such a total absence of good faith as to taint the entire proceeding requiring a dismissal of the Petition; and whether such a transfer shows a sufficient lack of good faith to require, at the very minimum,

the exclusion of the transferred property from the reorganization proceeding and the vacating of the restraining order relative to said property.

IV.

Specification of Errors Relied Upon.

The specification of errors relied upon are set forth in detail in the Opening Brief filed by Appellant and will not be repeated here.

V.

Argument

The primary issue before this Court is whether the transfer of the Sorrento Property by Kahn and Tavares to University City on the eve of bankruptcy was done in good faith. Appellant submits that the intent of Tavares and Kahn at the time they acquired title to the Sorrento Property from Sorrento Properties, Inc. on December 30, 1966 and the intent of Tavares and Kahn at the time they transferred title to University City on April 20, 1967 are the crucial relevant factors to be considered on the issue of good faith.

There is no dispute on the record as to either the method by which University City acquired title to the Sorrento Property or the intent of Tavares and Kahn at each step of the proceedings.

As of December, 1966, the 900 acres designated herein as the Sorrento Property was owned by a California corporation entitled Sorrento Properties, Inc. [V. I; 29:18-31:11]. As of December, 1966, this corporation was owned two-thirds by Tavares and one-third by Kahn [V. I; 31:7-11]. On December 30, 1966, Sorrento Properties, Inc. was dissolved and all assets and liabilities of Sorrento Properties, Inc., including the 900

acres designated herein as the Sorrento Property, was transferred two-thirds to Tavares and one-third to Kahn individually [V. I; 31:5-15; Ex. J.]. The intent of the parties at the time of the transfer of the Sorrento Property from Sorrento Properties, Inc. to Tavares and Kahn is best expressed by the following testimony of Tavares at the good faith hearing:

> [By Mr. Dunlavey]
> "Q. Was the intent at the time these Deeds were executed, this was going to be the first step toward putting Sorrento Property over into the University City?
> A. This was not the first step in putting this property into University City." [V. II; 83:12-16].
>
> * * * *
>
> [By Mr. Dunlavey]
> "Q. Can you tell me, Mr. Tavares, either yes or no, whatever the explanation you want to give after that, whether these Deeds were given at the time when you intended that the property ultimately was going to be reconveyed to University City.
> A. On my word of honor, no." [V. II; 84:1-7].

In April of 1967, immediately prior to the filing of the Reorganization Petition by University City, Kahn and Tavares transferred the Sorrento Property to University City [Ex. K]. The intent of the parties as to the purpose of this transfer is again best explained by the following testimony of Tavares:

> [By Mr. Dunlavey]
> "Q. And why was it you deeded that particular property to University City?

A. Well, we deeded it to University City because we wanted to protect our interest in the land that was being foreclosed by Sixty Trust." [V. I; 31: 20-24].

The Board of Directors of University City had full knowledge that such was the purpose of the transfer [Ex. D].

Thus, regardless of the evidence relied upon by Appellee Enright at pages 6 through 10 of his Brief, it is clear that the dissolution of Sorrento Properties, Inc. on December 30, 1966 was not the first step in putting the Sorrento Property into University City and that the individual principals had no intent as of December 30, 1966 to transfer the Sorrento Property to University City. The transfer to University City was only ultimately made by Kahn and Tavares on April 20, 1967 to save their individual equity in the Sorrento Property from being foreclosed by Appellant. These are the pertinent facts that compel the conclusion that the transfer exhibits such a lack of good faith as to dictate a dismissal of the entire reorganization proceeding, or at the very least, a segregation of the Sorrento Property from the remaining assets and the vacating of the restraining order as to such property so as to allow Appellant to proceed to foreclose its deeds of trust thereon.

Appellee Enright states that the Court should ignore this pertinent conclusive testimony and should look to the other factors outlined at pages 6 through 10 of his Brief. Thus, he refers to a prior history of dealings and states that "the original shareholders and principals of both University City and Sorrento Properties, Inc. . . . are substantially the same" (Brief for Appellee Enright, p. 6) and further that "Sorrento Properties,

Inc. [was] owned by the same principals as University City." (Brief for Appellee Enright, p. 6). Such was not the case. Since 1964, Carlos Tavares and Irvin J. Kahn were the only shareholders of University City who also held an ownership interest in Sorrento Properties, Inc. [V. I; 63:9-19]. In addition to Kahn and Tavares, the shareholders of University City included Louis Lesser Enterprises, Ltd. which owned 20%, Mr. Carlstrom who owned 20%, and Mr. Smith who owned 10% [V. I; 44:3-18]. None of these individuals had any ownership in Sorrento Properties, Inc. from 1964 to its dissolution. Accordingly, since at least 1964, the holders of 50% of the stock of University City had absolutely no proprietary interest in Sorrento Properties, Inc. Obviously, University City and Sorrento Properties, Inc. were separate corporations with separate ownership.

Appellee Enright also states that the Sorrento Property was "immediately adjacent" to the land owned by University City (Brief for Appellee Enright, p. 9). Such is not the case. The Sorrento Property consists of six non-contiguous separate parcels, each of which is a considerable distance from the land owned by University City and from each other [Ex. 3]. The "one development" idea was obviously not true in December of 1966 since Tavares testified that he had no intent at that time of transferring the Sorrento Property to University City [V. II; 83:12-84:7].

Appellee Enright also indicates that merger discussions occurred between the principals of University City and Sorrento Properties, Inc. in 1963 and 1965 (Brief for Appellee Enright, p. 9). Significantly, however, no merger ever took place.

Appellee University City also urges this Court to ignore the admitted purpose of the transfer of the Sorrento Property to University City because University City allegedly acceded to a large equity in the Sorrento Property by accepting the same in full payment of a receivable in the amount of $2,661,813.09 owed by Sorrento Properties, Inc. [V. I; 82:11-83:18] and assumed by Kahn and Tavares on the dissolution of Sorrento Properties, Inc. [Ex. I]. The alleged equity presumably stems from the difference between the value of the Sorrento Property, found by the Referee and approved by the District Court, to be $5,000,000 and the receivable of $2,661,813.09. The finding of value was premised solely upon the testimony of Carlos Tavares, admitted over the objection of Appellant, to the effect that the property was worth $5,000,000 [V. I; 25:10-23]. Appellant contended and still contends that such testimony of a person admittedly interested in the outcome of the proceeding cannot be sustained in light of the fact that the Sorrento Property was acquired from 1959 to 1962 for a total purchase price of $1,320,798.00 [Ex. H; V. I; 62:14-17; V. II, 59:21-24]. Except for some water and sewer lines, the Sorrento Property is in the same raw, undeveloped, unimproved condition as when acquired [V. I; 62:2-5; V. II; 65:2-12]. The terrain is rolling with gullies [V. II; 75:25-26] and has not been graded [V. II; 65:2-5]. It has no access to any freeway or roads [V. II; 65:2-5; V. II; 65:10-12] and is several years away from development [V. II; 113:23-114:1].

As late as 1964, Tavares purchased the one-third interest of Louis Lesser Enterprises, Ltd. in Sorrento Properties, Inc. for a $500,000 non-interest-bearing

note [V. 1; 63:9-19]. Accordingly, as late as 1964, even the owners of the Sorrento Property valued it at not more than $1,500,000. To say that the same property valued by the parties at $1,500,000 in 1964 is somehow magically worth $5,000,000 in 1967 is contrary to reason and logic. Accordingly, Appellant submits that University City acceded to no equity in the property.

In point of fact, another reason for the transfer by Kahn and Tavares of the Sorrento Property to University City probably stems from their fear that the Trustee in Reorganization would look to them for payment of the $2,661,813.09 receivable which they assumed at the dissolution of Sorrento Properties, Inc. [Ex. 1]. Instead of paying this amount, however, they discharged the receivable of $2,661,813.09 by transferring the Sorrento Property which they had valued as recently as 1964 as being worth only $1,500,000.

Appellant submits that all of the arguments advanced by Appellees are mere window dressings designed to hide the crucial elements of the intent and purpose behind the transfer. Even Appellee University City admits that the fact that property was transferred to a debtor for the purpose of obtaining the injunctive protection offered by Chapter X is a factor to be considered in determining good faith (Brief for Appellee University City, p. 8). Appellee University City relies heavily upon *In re Knickerbocker Hotel Co.* (7th Cir. 1936, 81 F. 2d 981) but fails to point out to the Court the rather unique factual situation that existed in that case. In *Knickerbocker,* a corporation had issued bonds secured by a deed of trust. Upon default in the bonds, a bondholder's protective committee was organized and approximately 98% of the unpaid bonds were deposited

with such committee. The Trustee under the indenture securing the bonds filed an action to foreclose the mortgage in a state court and a receiver was appointed to operate the properties. The bondholder's committee bid in at the foreclosure sale and purchased the property. The bondholder's committee, with the approval of the holders of 98% of the unpaid bonds, formulated a plan for reorganization which they sought to effectuate in the state court proceeding. The chancellor refused to confirm the sale or the plan, removed the receiver and enjoined any person from bringing about a reorganization. This order was reversed subsequently on appeal. The bondholder's protective committee thereupon organized a corporation and conveyed title to the property to said corporation subject to the bonds. The newly-formed corporation filed a Petition for Reorganization under the then applicable Section 77B of the Bankruptcy Act.

The Circuit Court's refusal to find bad faith in *Knickerbocker* is clearly distinguishable from the instant action. Thus, in *Knickerbocker,* the Petition was filed by a corporation organized by the holders of 98% of the bonds, who were actually the secured creditors who had become the owners of the property by bidding at the foreclosure sale. The state court had refused to approve the sale at the instance of a few of the remaining 2% holders of the bonds. In approving the organization of the corporation and the filing of the Petition for Reorganization, the Circuit Court stated as follows:

> "We find that a large bond issue has been floated on corporate property; default made; foreclosure proceedings instituted in the state court; receiver

appointed by state court who went into possession and operated the property for more than five years prior to the petition herein; a gross income of more than two and one-half million dollars collected; $85,000 paid to the receiver for his compensation; $31,500 paid to receiver's attorney; nothing paid to bondholders by way of principal or interest; taxes in the sum of $101,000 permitted to accumulate and remain unpaid; value of property shrunk far below incumbrance. Finally a plan of reorganization was worked out which was satisfactory to 98 per cent of the bondholders who were the real owners of the property. The state courts being somewhat restricted in making effective proposed reorganizations when confronted by minority opposition (see Chicago Title and Trust Co. v. Robin, 361 Ill. 261, 198 N.E. 4. Chicago Title and Trust Co. v. Bamburg, 361 Ill. 291, 198 N.E. 10), it was deemed advisable to proceed with a foreclosure sale of the property which was bid in by the bondholders' committee. At the instance of a few of the 2 per cent. of non-assenting bondholders the state court declined to approve the sale, essayed by injunction to retain control, brought forth a fresh receiver, and entered upon the announced purpose of a further period of receivership operation.

The bewildered bondholders were thus confronted with a condition and not a theory; they had invested their money in bonds of a corporation which had become insolvent through the crash of real estate values and other causes over which they had no control; they had honestly, as we believe,

taken various steps to bring about a fair adjustment of the unfortunate situation and had been thwarted in their purpose. Ninety-eight per cent. of them still had faith that a court of equity somewhere, somehow, would deliver them from bondage.

It is said that the purpose of Congress in the enactment of sections 77A and 77B of the Bankruptcy Act (11 U.S.C.A. §§206, 207) was the creation of machinery for the relief of distressed corporate debtors, yet equally important are the provisions which prevent a minority group from defeating the worthy plan of a majority—in short it is designed to prevent a minority group from developing a "nuisance" value far in excess of the actual value of their claims."

In re Knickerbocker Hotel Co., 81 F. 2d 981, 984.

The Court further stated that:

"Stripped of the equities with which this case abounds, a different situation would, however, be presented." *In re Knickerbocker Hotel Co.,* 81 F. 2d 981, 985.

* * * *

"Courts of equity will not aid those who defraud or deceive, but search as we may the conduct of the bondholders throughout these proceedings we find nothing that would justify a court of equity in closing its doors to them. On the contrary, their unfortunate situation cries loudly for relief." *In re Knickerbocker Hotel Co.,* 81 F. 2d 981, 985.

Under such circumstances, the *Knickerbocker* case provides no solace for Appellees. Here we have two individuals owning property and transferring it to a con-

trolled corporation solely to protect their own equity from a foreclosure sale scheduled by the secured creditors. In *Knickerbocker,* we had 98% of the secured creditors purchasing the property at a foreclosure sale and seeking court aid to prevent the remaining 2% from, as stated by the Circuit Court, "developing a 'nuisance' value far in excess of the actual value of their claims" (at p. 984).

Accordingly, Appellees do not and cannot dispute that the sole purpose of the transfer by Tavares and Kahn of the Sorrento Property to University City was to avail themselves of the injunctive power of the District Court so as to protect their individual equity in the Sorrento Property and to hinder, delay and prevent Appellant from proceeding with the noticed foreclosure sale under its deeds of trust. Under such circumstances, the transfer cannot be sanctioned.

Milwaukee Postal Building Corp. v. McCann, 95 F. 2d 948;

In re North Kenmore Building Corp., 81 F. 2d 656;

Shapiro v. Wilgus, 287 U. S. 348.

VI.
Conclusion.

Appellant submits that the District Court erred in refusing to follow well-established precedents and that it erred in approving and adopting the Report of the Referee, the Findings of Fact and Conclusions of Law promulgated by the Referee. Appellant also submits that the District Court erred, as a matter of law, in approving the Petition as having been filed in good faith since the only Order consistent with the evidence and established authorities is that the transfer by Kahn

and Tavares of the Sorrento Property to University City on the eve of filing the Petition for Reorganization solely to bring such property within the injunctive power of the District Court so as to restrain Appellant from proceeding with its foreclosure sales demonstrates such a lack of good faith to compel, as a matter of law, the dismissal of the instant reorganization proceedings. Such a dismissal is peculiarly appropriate here since the Board of Directors of University City acquiesced in the transfer with full knowledge of its intent and purpose.

Accordingly, The Sixty Trust respectfully petitions the Court of Appeals for its judgment reversing the order of the District Court approving the Petition and directing the District Court to dismiss said Petition as not having been filed in good faith.

Alternatively, The Sixty Trust respectfully petitions the Court of Appeals for its judgment reversing the District Court's approval of the Petition insofar as it relates to the Sorrento Property and directing that the Sorrento Property be segregated from the remaining assets of this estate, that the Order restraining the stay be vacated insofar as it relates to such property, and that Appellant herein be given leave to enforce its liens against said property and to foreclose its deeds of trust thereon in accordance with the terms thereof as authorized by the laws of the State of California.

Respectfully submitted,

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